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# Supreme Court of the United States

**OCTOBER TERM, 1928.**

No. 37

WABASH RAILWAY COMPANY, MYRON S. HALL, H. W. COHU, *et al.*,
*Petitioners,*

*vs.*

JOHN C. BARCLAY AND WILLOUGHBY COMPANY.

No. 38

SHIRLEY P. AUSTIN,
*Petitioner,*

*vs.*

JOHN C. BARCLAY AND WILLOUGHBY COMPANY.

## BRIEF ON BEHALF OF PETITIONERS.

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## TABLE OF CONTENTS.


| | PAGE |
|---|---|
| STATEMENT | 1 |
| I. Preliminary | 1 |
| (a) Jurisdiction of this Court | 1 |
| (b) Jurisdiction of the District Court | 2 |
| (c) Nature and purpose of suit | 2 |
| (d) Proceedings in the District Court | 3 |
| (e) Proceedings in the Circuit Court of Appeals | 4 |
| II. The Underlying Facts | 4 |
| III. The Underlying Legal Question | 8 |
| ARGUMENT | 9 |
| I. In the absence of language creating a different obligation, the holders of a non-cumulative Preferred Stock who do not become entitled by appropriate declaration to dividends for a particular fiscal year, have no right to require that dividends for such year be added to the dividends declared for a subsequent year | 9 |
| II. The language of the Preferred A Stock contract of Wabash Railway Company definitely excludes a construction under which the investment of earnings in im- | |

PAGE

provements and equipment or working capital in non-dividend or partial dividend years operates as a permanent restraint against the distribution of earnings of subsequent years ..... 34

III. An analysis of the authorities relied upon by the respondents fortifies the legal conclusions above expressed ..... 43

IV. The decision of the Circuit Court of Appeals should be reversed and the case remanded to the Circuit Court of Appeals under a mandate for affirmance of the decree of the District Court ..... 48

## Table of Cases Cited.


| | PAGE |
|---|---|
| Bailey *v.* Railroad Company, 17 Wallace 96 ..... | 9 |
| Bassett *v.* U. S. Cast Iron Pipe & Foundry Company, 74 N. J. Eq. 668; aff. 5 N. J. Eq. 539 .... | 22, 28 |
| Boardman *v.* Lake Shore & Michigan Southern Railway Company, 84 N. Y. 157 ..... | 43 |
| Burk *v.* Ottawa Gas and Electric Company, 123 Pac. 857 ..... | 43, 47 |
| Collins *v.* Portland Electric Power Company, 12 Fed. Rep. (2nd Series) 671 ..... | 44 |
| Continental Insurance Company *v.* United States, 259 U. S. 156 ..... | 15, 28, 34 |
| Day *v.* U. S. Cast Iron Pipe & Foundry Company, 96 N. J. Eq. 736 ..... | 22 |
| Dent *v.* London Tramways Company, L. R. 16 Ch. Div. 344 ..... | 43 |
| Missouri Pacific Railroad Company *v.* Texas and Pacific Railway Company and others, 282 Fed. Rep. 61 ..... | 47 |
| Moran and Day *v.* U. S. Cast Iron Pipe & Foundry Company, 95 N. J. Eq. 389 ..... | 22 |
| Moran *v.* U. S. Cast Iron Pipe & Foundry Company, 96 N. J. Eq. 698 ..... | 22 |
| New York, Lake Erie & Western Railroad Company *v.* Nickals, 119 U. S. 296 ..... | 10 |
| Norwich Water Power Company *v.* Southern Railway Company, 11 Virginia Law Register (N. S.) 203 ..... | 33 |
| Star Publishing Company *v.* Ball, 134 N. E. 285.. | 43 |
| Wood *v.* Lary, 47 Hun 550 ..... | 43, 47 |

**Supreme Court of the United States,**

October Term, 1928.

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No. 693.

WABASH RAILWAY COMPANY, MYRON S. HALE, H. W. COHU, *et al.*,

*Petitioners,*

*vs.*

JOHN C. BARCLAY AND WILLOUGHBY COMPANY.

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No. 694.

SHIRLEY P. AUSTIN,

*Petitioner,*

*vs.*

JOHN C. BARCLAY AND WILLOUGHBY COMPANY.

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# BRIEF ON BEHALF OF PETITIONERS.

## STATEMENT.

### I.

### Preliminary.

*(a) Jurisdiction of this Court.*

This case is presented to this Court upon writs of certiorari to the United States Circuit Court of Appeals for the Second Circuit to review a decree of that Court

filed January 14, 1929, reversing a decree of the District Court of the United States for the Southern District of New York filed January 16, 1928, dismissing the bill of complaint upon the merits (Tr., pp. 47; 83; 86).

*(b) Jurisdiction of the District Court.*

The suit was brought in the United States District Court for the Southern District of New York by John C. Barclay, a citizen and resident of the State of New Jersey against Wabash Railway Company, a corporation of the State of Indiana and certain individuals, all of whom are citizens and residents of States other than the State of New Jersey and the bill of complaint alleges that the suit is one of a civil nature in equity and that the matter in controversy, exclusive of interest and costs, exceeds $3,000 (Tr., pp. 1, 2).

*(c) Nature and purpose of suit.*

The plaintiff, John C. Barclay, a holder of Five Per Cent. Profit Sharing Preferred Stock A of Wabash Railway Company, brought this suit to establish a dividend credit amounting to many millions of dollars in favor of the Preferred Stock A and to enjoin payment of dividends upon the Convertible Preferred Stock B and Common Stock of the Railway Company until such dividend credit shall be extinguished (Tr., pp. 1; 5; 6; 7; 8). The bill of complaint alleges that the holders of the Preferred Stock B and Common Stock are numerous and widely scattered and that Myron S. Hall, H. W. Cohu and LaMotte T. Cohu, co-partners owning and holding 2,197 shares of the Preferred Stock B have been made parties defendant as representatives of the holders of Preferred Stock B and that Gerald V. Hollins, Shirley P. Austin and George R. Leslie, co-partners owning and holding

15,505 shares of Common Stock, and Earl Krapp, owner and holder of 1,500 shares of Common Stock have been made parties defendant as representatives of the holders of Common Stock (Tr., p. 3). Prior to the hearing in the District Court, William Fraser Dickson, a resident of the State of Pennsylvania and the holder and owner of Common Stock, intervened and was made a party defendant (Tr., p. 32). After entry of the decree in the District Court, the Willoughby Company, a corporation of the State of Pennsylvania and a holder of Preferred Stock A, intervened and was made a party plaintiff—such intervention being in subordination to and in recognition of the propriety of the main proceeding and without prejudice to any proceedings theretofore had in the cause (Tr., p. 59).

*(d) Proceedings in the District Court.*

After answers to the bill of complaint had been filed by the Railway Company and by all other defendants excepting the intervener Dickson, the plaintiff applied to the District Court (Judge Francis A. Winslow) for a temporary injunction to restrain payment of dividends upon the Preferred Stock B and Common Stock of the Railway Company until preferential dividends at the rate of 5% in each year upon the Preferred Stock A from the date of the organization of the Railway Company to and including the year 1926 "to the extent that the Railway Company has had net earnings available for the payment of such dividends and to the extent that such dividends remain unpaid" shall have been paid to the holders of said Preferred Stock A (Tr., p. 39).

At the same time, the defendant Dickson applied for an order dismissing the bill of complaint for want of equity (Tr., p. 46).

After full hearing upon these motions, the suggestion was made by the District Court and was accepted by all counsel in open Court that the defendant Dickson withdraw his motion to dismiss the bill of complaint and file an answer thereto and that the plaintiff's motion for an injunction be treated as a motion for a final decree on the pleadings; and an order making this arrangement effective was entered by the District Court on December 28, 1927, upon stipulation (Tr., p. 47).

On January 12, 1928, Judge Winslow filed an opinion directing the dismissal of the bill of complaint on the merits and on the same date a decree to this effect was entered (Tr., p. 48).

*(e) Proceedings in the Circuit Court of Appeals.*

The original plaintiff Barclay, and the added plaintiff, Willoughby Company, appealed to the Circuit Court of Appeals from the decree of the District Court and on January 14, 1929, the Circuit Court of Appeals—Circuit Judge Learned Hand dissenting—ordered that the decree be reversed. The prevailing opinion of the Circuit Court of Appeals was written by Circuit Judge Manton and was concurred in by Circuit Judge Augustus N. Hand (Tr., pp. 65-83).

## II.

## The Underlying Facts.

Wabash Railway Company was organized October 22, 1915, under the laws of the State of Indiana with three classes of capital stock:

$46,200,000 of 5% Profit Sharing Preferred Stock A.

$49,970,000 of 5% Convertible Preferred Stock B.
$47,290,000 of Common Stock.
(Tr., pp. 8; 9; 10).

The shares of each of the above issues are of the par value of $100 (Tr., p. 9).

The Preferred Stock A by its terms is non-cumulative (Tr., p. 10).

The Preferred Stock B also by its terms non-cumulative is convertible after August 1, 1918 into Preferred Stock A and Common Stock, one share of Preferred Stock B being exchangeable for 50% of its par value in Preferred Stock A and 50% of its par value in Common Stock (Tr., p. 11).

The Preferred Stock A is preferential in dividends as against both the Preferred Stock B and the Common Stock and the Preferred Stock B is preferential in dividends as against the Common Stock, each of these Preferred issues being entitled to receive 5% dividends in each year in preference and priority to the junior stock or stocks (Tr., p. 10). After payment or setting apart in any one fiscal year of 5% dividends on the Preferred Stock A and the Preferred Stock B and on the Common Stock, the Preferred Stock A and Common Stock participate equally in any further dividend distributions (Tr., p. 10). In the event of liquidation, the Preferred Stock A is entitled to be paid its full par value, and all dividends thereon *declared* and unpaid, before any payment is made to the Preferred Stock B or Common Stock; the Preferred Stock B is entitled to be paid its full par value, and all dividends thereon *declared* or unpaid, before any payment is made to the Common Stock; but after the payment in full of these amounts to the Preferred A and to the Preferred B stocks, all three classes

share equally in the distribution of any remaining assets (Tr., p. 10). The Preferred Stock A is redeemable after December 1, 1920, at the price of 110% of its par value (Tr., p. 10). The Preferred Stock B is entitled to preferential dividends in each fiscal year up to five per cent. after payment of the full five per cent. dividend on the Preferred Stock A but before any dividend shall be paid upon the Common Stock (Tr., pp. 10, 11). All three classes of stock have equal voting rights (Tr., p. 19).

For convenience, the pertinent part of the text of the certificate for the Preferred Stock A and the corresponding text of the Certificate of Incorporation are set out in the subjoined Appendix p. 49.

The foregoing indicates the salient features of the financial structure of the Railway Company.

In every fiscal year from the date of the organization of the Railway Company to the year 1926, excepting two years, there were net earnings. In certain of these years, however, the Board of Directors declared no dividend on the Preferred Stock A or declared a dividend at a rate lower than 5%. (Tr., pp. 4; 21; 22; 40). It was the judgment of the Board of Directors that these earnings ought not to be used for the payment of dividends but should be applied to the development and improvement of the property which had only recently emerged from receivership (Tr., pp. 21; 22). The bill of complaint does not challenge the good faith or the propriety of this action of the Board of Directors. On the contrary, the bill of complaint itself avers that the entire amount thus applied "was carried to the surplus of the Railway Company *and used for additional working capital and for other proper corporate purposes.*" (Italics ours). (Tr., Complaint Par. Tenth, p. 5).

The answer of the Railway Company, which stands admitted by the plaintiff's motion for a decree on the pleadings, contains the following allegation:

"The Railway Company admits the allegations contained in paragraph Eighth of the Complaint respecting the payment and non-payment of dividends between the years 1915 and 1926, but it denies that there were large net earnings available for dividends on its Preferred Stock 'A' in the period mentioned in said paragraph and denies that its earnings in any part or parts of said period justified the payment of any dividends which were not actually paid, and, although admitting balances of net earnings in certain non-dividend periods over expenses and prior charges, the Railway Company denies that any part of such balances could, consistently with its lawful obligations to its stockholders, or with its duties to the public in safe and efficient maintenance of property and service, or with sound discretion and the duty of its directors, have been distributed to stockholders, and avers that its entire surplus earnings of all periods since the incorporation of the Railway Company not actually distributed to stockholders and not reserved for working capital or necessary corporate requirements has been actually appropriated to and is now represented by fixed and permanent improvements and additions to the property and equipment of the Railway Company to enable it adequately to discharge its public duties and protect its property, and that no part of such alleged surplus is represented by any cash or liquid fund or by any accumulation of cash assets available for dividends" (Tr., pp. 21-22).

It is thus alleged in the answer and admitted by the respondents that no part of the earnings of non-dividend years could consistently, with the lawful obligations of the Railway Company to its stockholders and of its duties to the public in safe and efficient maintenance of property and service or with the sound discretion and duty of its Directors, have been distributed to stockholders, and that its entire surplus earnings of all periods since its incorporation, not actually distributed to the stock-

holders and not reserved for working capital or necessary corporate requirements, has been actually appropriated to and is now represented by *fixed and permanent improvements and additions to the property and equipment of the Railway Company to enable it adequately to discharge its public duties and protect its property and that no part of its alleged surplus is represented by any cash or liquid fund or by any accumulation of cash assets available for dividends* (Tr., pp. 21; 22).

## III.

## The Underlying Legal Question.

Stated broadly, the question now presented to this Court is whether the Preferred Stock A of the Railway Company which by its express terms is non-cumulative is nevertheless cumulative *quo ad* any net earnings accruing in non-dividend or partial dividend years which the Board of Directors (elected by the preferred and common stockholders with equal voting rights, and with the preferred stockholders always in the majority) in the exercise of an unquestioned discretion determined should not be distributed but should be invested, and which have actually been invested, in the property or held for working capital.

In asking that such quasi-cumulative character be given to the Preferred Stock A of Wabash Railway Company, the respondents—as we understand their position—do not rely upon any special or unusual stipulation in the Preferred A stock contract but rely entirely upon what they conceive to be the right as a matter of general law of the holders of a non-cumulative preferred stock.

The petitioners contend that the right thus claimed by the respondents (a) is not an ordinary incident of non-cumulative preferred stock, and (b) regardless of the rule governing non-cumulative stock in ordinary cases is a right which is definitely excluded by the terms and provisions of the Preferred A Stock of Wabash Railway Company.

## ARGUMENT.

### I.

**In the absence of language creating a different obligation, the holders of a non-cumulative Preferred Stock who do not become entitled by appropriate declaration to dividends for a particular fiscal year, have no right to require that dividends for such year be added to the dividends declared for a subsequent year.**

Wabash Railway Company is a corporation of the State of Indiana, but there is no statute of that State or controlling decision of its Courts which takes the case out of the application of general principles.

One of the earliest cases in this Court involving non-cumulative Preferred Stock is *Bailey* v. *Railroad Company*, 17 Wallace 96 (1872).

This case related to non-cumulative Preferred Stock issued by the Hannibal and St. Joseph Railroad Company and the point in controversy was whether or not the Preferred Stock and Common Stock participated *pro rata* in the year's surplus after the payment of the full non-cumulative preferred dividend. The following is from the opinion of Mr. Justice Clifford (p. 109):

> "Holders of preferred stock, as there provided, are entitled to receive all the net earnings

> of the company *which may be divided* (our italics) pursuant to the indenture in each year up to $7 per share, and to share in any surplus beyond $7 per share *which may be divided* (our italics) upon the common stock, which in substance and legal effect is the same regulation as that contained in the circular or plan, and all the other writings upon the subject which were given in evidence at the final hearing."

It is to be noted that even at this early date it was clearly understood that the rights of the non-cumulative Preferred Stock like those of Common Stock related to earnings that were *divided* and not to earnings that were withheld from distribution by directors in the exercise of sound discretion.

The principles of law governing the rights of non-cumulative Preferred Stock are clearly set forth in the opinion of this Court in *New York, Lake Erie & Western Railroad Company* v. *Nickals*, 119 U. S. 296 (1886).

At the outset it therefore becomes important to analyze this decision and to indicate what was decided and the reasons therefor and its bearing upon the case now presented to this Court.

The New York, Lake Erie & Western Railroad Company was organized to acquire at a foreclosure sale pursuant to a plan and agreement of reorganization, properties theretofore owned by the Erie Railroad Company. The plan and agreement provided for an issue of Preferred Stock "entitling the holders to non-cumulative dividends, at the rate of six per cent. per annum, in preference to the payment of any dividend on the Common Stock, but dependent on the profits of each particular year as declared by the Board of Directors."

In the Articles of Association of the reorganized Company, it was provided that the holders of the Preferred Stock shall be entitled to "non-cumulative dividends at the rate of six per cent. per annum in preference to the

payment of any dividend on Common Stock''—the words "but dependent on the profits of each particular year, as declared by the Board of Directors'' being omitted.

While this Court thought that the omission of these words from the Articles of Association was significant, it reached its decision "independently of this view'' (pp. 304, 305).

The facts were:

The new company was organized in 1878. On December 9, 1880, the directors submitted a report of operations for the fiscal year ending September 30, 1880, showing net earnings from traffic of $7,049,183.51 and total net earnings of $7,833,140.16. Deducting interest and fixed charges, there remained "a net profit from operations of the year of $1,790,620.71''. The directors said that this amount had been applied "to the building of double track, erection of buildings, providing additional equipment, acquiring and constructing docks at Buffalo and Jersey City and to the addition of other improvements to the road and property''. The preferred stockholders sued to compel the payment of the non-cumulative preferred dividend on the theory that the net profit for the fiscal year ended September 30, 1880, constituted a fund applicable primarily to the payment of the 6% dividend on the preferred stock and that it was a breach of trust to apply it otherwise (p. 302).

This view was sustained by the Court below which held (15 Fed. Rep. 575):

> "The question becomes more one of right, to be determined by the law, than one of policy, to be determined by the discretion of the directors. Here were profits in fact; the preferred stockholders had rights dependent upon this fact. These rights could not lawfully be passed by for the benefit of other interests, however intimately connected, any more than any other property of the preferred stockholders could be appropriated to

the same purpose, on the ground that such appropriation of it would be for the best good of the whole."

The Court below also said:

"Here these dividends are non-cumulative, and if the holders of this stock do not get these dividends in each particular year they never can have them. The improvement of the property by the expenditure of the money belonging to them goes to the benefit of the other owners, and not to them, so long as it would pay the dividends on the preferred stock without the expenditure."

This decision was unanimously reversed by this Court, which in an opinion by Mr. Justice Harlan said (p. 305):

"What was stipulated to be paid to them as holders of preferred stock in the new company was not a *debt,* payable in every event out of the general funds of the corporation, but a *dividend,* 'as declared by the board of directors,' and payable out of such portion of the profits as should be set apart for distribution among shareholders; non-cumulative, because 'dependent on the profits of each particular year,' and not to be fastened on the profits of succeeding years. That the parties contemplated a declaration of a dividend, and not a mere statement of net profits during a designated period is made evident by the requirement that 'dividends' to preferred stockholders should be paid 'in preference to the payment of any dividend on the common stock'. This language is not consistent with the theory that the holders of preferred stock were entitled to six per cent. thereon simply because there were profits, and irrespective of any declaration of a dividend. A declaration of profits, as, in itself, and without further action by the directors, entitling shareholders to dividends, is unknown in the law or in the practice of corporations. Dividends are 'declared' by some formal act of the corporation—the question

whether there are or are not profits being settled entirely by the accounts of the company as kept by subordinate officers, not by the mere statement of directors as to what appears upon its books.

A different view would lead to results which sound policy would seem to forbid, and which, therefore, it is not to be supposed were contemplated by the parties. For, if preferred stockholders become entitled to dividends upon a mere ascertainment of profits for a particular year, the duty of the company to maintain its track and cars in such condition as to accommodate the public and provide for the safe transportation of passengers and freight would be subordinate to their right to payment out of the funds remaining on hand after meeting current expenses and fixed charges. Indeed, there is some ground to contend that, according to appellees' interpretation of the charter, the directors were not at liberty, in any year when the current receipts were in excess of operating expenses, to pay even interest on funded debt, or rentals of leased lines, before paying a dividend on preferred stock. We are of opinion that while the agreement of 1877 and the articles of association sustain the claim of preferred stockholders to a six per cent. dividend in advance of common stockholders, the former are not entitled, of right, to dividends, payable out of the net profits accruing in any particular year, unless the directors of the company formally declare, or ought to declare, a dividend payable out of such profits; and whether a dividend should be declared in any year is a matter belonging in the first instance to the directors to determine, with reference to the condition of the company's property and affairs as a whole. As the evidence shows that the profits for the year ending September 30, 1880, were applied to objects that were legitimate and proper, and as the condition of the company was not such as to make the declaration of a dividend a duty upon the part of the directors, we perceive no ground upon which the claim of the appellees can be sustained."

The broad underlying principle of this decision is that the *right* of the preferred stockholder to a dividend is derived from a declaration by the Board of Directors who are to determine in the exercise of their sound discretion whether earnings shall be invested in plant or equipment or held for working capital or shall be distributed by way of dividends to stockholders. When the Board of Directors duly and in good faith determines to invest earnings of a particular dividend period in plant and equipment or to appropriate the same for working capital, the preferred stockholder is concluded by the action of the Board of Directors and if his stock is non-cumulative his dividend for this period is "not to be fastened on the profits of succeeding years".

It is submitted that this principle necessarily controls the present case.

The Board of Directors of Wabash Railway Company in the early period following reorganization, not only did not declare preferred dividends but determined to invest earnings in plant and equipment, a determination which forecloses any claim by the preferred stockholders against such earnings unless the action of the Directors involved an abuse of discretion, which it is conceded is not the case.

What the right, if any, of the preferred stockholder would be if the Board of Directors should subsequently change its policy and determine to distribute earnings theretofore withheld from the preferred stock is a question which does not arise in the present case. This is not a case where earnings previously invested in the property of the Railway Company or held for working capital are released from such appropriation and are to be distributed in whole or in part. This is a case where these investments are still held intact and not distributed and where the preferred stockholder is seeking to establish

an equitable lien or credit against invested surplus and thereafter to require the invested surplus to be liquidated for his account by the use of subsequent earnings; in short it is a case where the preferred stockholder is seeking to do what this Court in the *Nichols* case said he could not do, namely, *fasten* an undeclared non-cumulative dividend on the profits of succeeding years.

In his dissenting opinion in the Circuit Court of Appeals, Circuit Judge Learned Hand seems to assume that if the Directors hereafter should wish to reduce the working capital accumulated out of past earnings, they would probably be obliged to declare as preferred dividends the amount so withdrawn. Whatever plausible reasons may be assigned for this assumption, in support of which Judge Hand refers to two cases considered at a subsequent point in this brief, the question of what the rights of non-cumulative preferred stockholders would be in a dividend distribution of such a fund does not arise in this case, and is not now before this Court. It is, however, definitely settled that undivided earnings must be distributed "as capital assets" in the event of liquidation.

This Court so held in *Continental Insurance Company v. United States*, 259 U. S. 156 (1921).

In many aspects this case, which arose out of proceedings under the Federal Anti-trust laws against the Reading Company, is of such controlling importance that reference may appropriately be made to Poor's Manual of Railroads for the financial history of the Reading Company. (See Poor's Manual of Railroads; 1897-1922; 1928; Tr., p. 42).

The Reading Company was reorganized under the laws of Pennsylvania in December, 1896, with three classes of stock, viz.:

| | |
|---|---|
| $28,000,000 | 4% Non-cumulative First Preferred Stock |
| 42,000,000 | 4% Non-cumulative Second Preferred Stock |
| 70,000,000 | Common Stock |

The Organization Agreement under which the Company was reorganized, provided that the Preferred Stock should be entitled to non-cumulative dividends

> "at the rate of, but not exceeding, four per cent per annum, in each and every fiscal year, in preference and priority to any payment in or for such fiscal year, of any dividend on other stock; but only from undivided net profits of the Company when and as determined by the Board of Directors, and only if and when the Board shall declare dividends therefrom. If, after providing for the payment of full dividends for any fiscal year on the First Preferred Stock, there shall remain any surplus undivided net profits, the Board out of such surplus may declare and pay dividends for such year upon the Second Preferred Stock. If, from the business of any particular fiscal year, excluding undivided net profits remaining from previous years, after providing out of the net profits of such particular fiscal year for the payment of the full dividends for such fiscal year on the First and Second Preferred Stock, there shall remain surplus net profits, the Board of Directors may declare, and out of such surplus net profits of such year may pay, dividends upon any other stock of the Company. But no dividends shall in any year be paid upon any such other stock out of net profits of any previous fiscal year in which the full dividends shall not have been paid on the First and Second Preferred Stock."

In each of the years 1897 to 1900 inclusive, there were net earnings which might have been distributed as dividends on the Preferred Stock but no dividend was declared until 1900, in which year $1,227,335.35 was earned and a dividend of 3% (1% less than the full rate) amounting to $839,736, was declared and paid upon the First Preferred Stock. No dividend was paid on the Second Preferred Stock until 1903, when 1½% was declared. The full 4% dividend upon the First Preferred

Stock was declared in 1901 and on the Second Preferred Stock in 1904 and thereafter dividends at this rate were maintained. Dividends at varying rates were paid on the Common Stock between 1905 and 1912 and after 1912 dividends amounting to 8% annually were regularly declared upon the Common Stock.

The Reading Company having been adjudged to be an unlawful combination, was required by a decree of the District Court entered under mandate of this Court to distribute to stockholders certain assets representing accumulated earnings. From this decree certain Common stockholders appealed to this Court. This Court held that the effect of the decree was "in fact and in law a liquidation of the assets of the old Reading Company and a *pro rata* distribution of assets among the holders of the First Preferred Stock, Second Preferred Stock and Common Stock."

This Court approved this method of distribution as consistent with the contract rights of the respective stockholders and rejected a claim of the Common Stock to participate in the distribution to the exclusion of the Preferred Stocks.

The following is from the opinion of this Court, written by Mr. Chief Justice Taft:

> "It will be observed that the preferred stock and the common stock with 1,400,000 shares of each were thus given an equality of voting power which could not be changed without the consent of the company, and that it has not been changed either by conversion or redemption. This would seem to have been designed to preserve an equilibrium of control in which reasonable dividends out of profits when they accrued in sufficient amount would be voted to the common stockholders on the one hand, and proper additions would be made out of earnings to the capital of the company to increase its future profit-earning capacity and create a greater security for a constant payment of

dividends to preferred stockholders. Of course there would not be block voting of the two classes of stock but the division did tend to secure a fair representation of both interests in the board of directors.

The effect of the agreement as to dividends upon the preferred and common stock seems to us clear. It emphasizes that dividends are to be paid only out of undivided profits and when and as determined by the board of directors and only if and when the board shall declare them. It leaves to the board to determine in its discretion whether the undivided profits shall be put in surplus working capital or in dividends. The limitations on the discretion of the board are that the first and second preferred can not receive more than four per cent. in any fiscal year, and that neither the second preferred nor the common stock can receive any dividend until the first preferred dividend has been paid in full each year and the common stock receives nothing until the second preferred dividend is thus paid. The words describing the condition upon which the power of the board to declare dividends on the common stock can be exercised, show that each year's profits are to be considered by themselves in the distribution of dividends between the stock.

Appellants, however, rely on the final words of the clause to show that it is intended that net profits in any past year can be thereafter allowed to the common stock if in that past year the preferred stock had been paid full dividends. We do not find it necessary to decide that the board of directors has not such power; but if so, the power is not one the exercise of which can be compelled in the absence of fraud or breach of trust. The failure of the board to exercise it, and the application of the earnings to surplus determine such earnings to be assets as of the time of the compulsory winding up and liquidation of the corporation. The power to declare dividends not exercised can have no more effect upon the rights of the preferred stockholders to share in the exist-

ing assets of the corporation when liquidated than the failure of the company to convert preferred stock into common, or to redeem the preferred stock at par. The proper interpretation of the agreement is that, after the declaration of dividends for any current year, the undivided earnings are to be regarded as capital assets and to be distributed on liquidation, unless the board of directors has meantime applied them as dividends. If the argument of appellants were carried to its logical result, all the net earnings of the Reading Company in twenty-five years no matter how invested or applied to increasing the earning capital, must in a liquidation be treated as undistributed profits to go entirely to the common stock without any action of the board of directors. This is impossible."

In its essential features, this decision is irreconcilable with the claim now asserted by the Preferred A stockholders of Wabash Railway Company.

It is to be noted:

(a) In the years in which dividends upon the Preferred Stock of the Reading Company were not paid or were paid only in part there were substantial net earnings withheld from distribution and used for corporate purposes.

(b) Dividends upon the Second Preferred Stock were inaugurated in 1903 and were continued until the segregation without any payment being made to the First Preferred stockholders in respect of the years in which the First Preferred dividend, though earned in whole or in part, was not declared by the Board of Directors.

(c) Dividends upon the Common Stock were inaugurated in 1905 and were continued until the segregation without any payment being made to either issue of Preferred Stock in respect of the non-dividend or partial dividend periods.

(d) *The corporate surplus representing earnings withheld from distribution to all classes of stock was treated by this Court as assets to which no dividend credits or preferential equities attached and which was decreed to be distributed pro rata among all three classes of stock.*

The financial structure of the Reading Company is typical of those of most of the great railroad transportation companies in the country. These companies were nearly all organized or reorganized subsequent to the decision of this Court in the *Nickals* case with one or more issues of Preferred Stock which were either wholly non-cumulative or non-cumulative for a stated period of years after organization or reorganization. The underlying purpose of such a financial structure was to give to the Board of Directors discretionary power and authority freely to use corporate earnings in building up these properties to the standards necessary to enable them to discharge their public obligations—and it was a necessary and vital feature of a financial structure thus conceived that if in any year the Board of Directors found it necessary to apply to working capital or other corporate purposes income which otherwise might have been used for dividends the non-cumulative preferred stockholder was not entitled to any dividend distribution for that year but was to be compensated for his loss of income by the increased earning power of the corporation and the "greater security for a constant payment of dividends to the preferred stockholders". A list of the more important railroad companies with issues of non-cumulative preferred stock outstanding, is set out in the subjoined footnote.* This footnote has been compiled from

* Note: The Atchison, Topeka and Santa Fe Railway Company $124,199,500 5% non-cumulative Preferred Stock; Boston and Maine Railroad Company $38,817,900 non-cumulative Preferred Stock; Baltimore and Ohio Railroad Company $58,863,181 4% non-cumulative Preferred Stock; Buffalo, Rochester and Pittsburgh Railway

data contained in Poor's Manual of Railroads and Moody's Manual of Railroads which "are standard publications in general use for statistical purposes and are generally relied upon as accurate" (Tr., p. 40). From this data it appears that many of the companies—particularly in the earlier years—have pursued the same policy that was adopted by the Reading Company and the Wabash Company—the conservative policy of building up plant and equipment by the use of surplus earnings. Many companies, after building up their properties by the use of earnings accruing in years in which dividends were not declared upon the non-cumulative Preferred Stocks—as did the Reading Company and Wabash Railway Company—placed non-cumulative Pre-

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Company 6% non-cumulative Preferred Stock; Chicago & Alton Railroad Company $19,544,000 4% non-cumulative Preferred Stock; Chicago and Eastern Illinois Railway Company $22,046,000 6% Preferred Stock, non-cumulative prior to January 1, 1924; Chicago Great Western Railroad Company $47,133,002 4% Preferred Stock, non-cumulative prior to June 30, 1914; Chicago, Indianapolis & Louisville Railway Company $4,991,300 4% non-cumulative Preferred Stock; Chicago, St. Paul, Minneapolis and Omaha Railway Company $11,259,859 7% non-cumulative Preferred Stock; Cleveland, Cincinnati, Chicago & St. Louis Railway Company $9,998,500 5% non-cumulative Preferred Stock; Colorado & Southeastern Railroad Company $8,500,000 4% non-cumulative First Preferred Stock; $8,500,000 4% non-cumulative Second Preferred Stock; Duluth, South Shore & Atlantic Railway Company $10,000,000 6% non-cumulative Preferred Stock; Erie Railroad Company $47,904,400 4% non-cumulative First Preferred Stock; $16,000,000 4% non-cumulative Second Preferred Stock; Gulf, Mobile & Northern Railroad Company $1,415,600 6% Preferred Stock, non-cumulative prior to January 1, 1920; Kansas City Southern Railway Company $21,000,000 4% non-cumulative Preferred Stock; Minneapolis, St. Paul & Sault Ste. Marie Railway Company $12,603,400 7% non-cumulative Preferred Stock; Missouri-Kansas-Texas Railroad Company $45,884,623 7% stock, non-cumulative prior to January 1, 1928; Norfolk and Western Railway Company $22,992,300 4% non-cumulative Adjustment Preferred Stock; Pere Marquette Railway Company $12,429,000 5% Preferred Stock, non-cumulative prior to January 1, 1919; St. Louis-San Francisco Railway Company $7,145,100 6% non-cumulative Preferred Stock; St. Louis Southwestern Railway Company $16,000,000 5% non-cumulative Preferred Stock; Seaboard Air Line Railway Company $37,300,000 6% non-cumulative Preferred Stock; $23,894,100 4.2% non-cumulative Preferred Stock; Southern Railway Company $60,000,000 5% non-cumulative Preferred Stock; Union Pacific Railroad Company $99,543,500 4% non-cumulative Preferred Stock; Western Maryland Railway Company $8,561,000 4% non-cumulative Preferred Stock; Wheeling and Lake Erie Railway Company $11,882,600 7% Preferred Stock, non-cumulative prior to November 1, 1916; $10,334,958 6% non-cumulative Preferred Stock.

ferred Stocks upon a dividend basis and also inaugurated dividends upon junior stocks.†

That the mere realization of net earnings in non-dividend or partial dividend years should result in the creation of a dividend credit giving cumulative rights *pro tanto* to non-cumulative Preferred Stock is, we submit, an idea developed recently and directly traceable to a misinterpretation of decisions which do no more than give effect to the special statutory law and policy of the State of New Jersey.

For this reason an analysis of these decisions seems appropriate:

*Bassett* v. *U. S. Cast Iron Pipe & Foundry Company*, 74 N. J. Eq. 668. Aff. 75 N. J. Eq. 539 (1909);

*Moran and Day* v. *U. S. Cast Iron Pipe & Foundry Company*, 95 N. J. Eq. 389 (1924);

*Moran* v. *U. S. Cast Iron Pipe & Foundry Company*, 96 N. J. Eq. 698 (1924);

*Day* v. *U. S. Cast Iron Pipe & Foundry Company*, 96 N. J. Eq. 736 (1924).

Section 18 of the New Jersey Corporation Act, after authorizing corporations to issue Preferred Stock, provides as follows:

> "The holders thereof shall be entitled to receive and the corporation shall be bound to pay thereon a fixed yearly dividend to be expressed in the certificate, not exceeding eight per centum, pay-

†Note: The companies in this category include the Buffalo, Rochester and Pittsburgh Railroad Company; Chicago, Indianapolis and Louisville Railway Company; Chicago, St. Paul, Minneapolis & Omaha Railway Company; Cleveland, Cincinnati, Chicago and St. Louis Railway Company; The Colorado & Southern Railway Company; Erie Railroad Company; The Kansas City Southern Railway Company; Minneapolis, St. Paul, Sault Ste. Marie Railway Company; Norfolk & Western Railway Company; Southern Railway Company; Union Pacific Railroad Company. This list is limited to railroad companies and even as to these does not purport to be complete. There are certainly hundreds of industrial companies similarly situated.

able quarterly, half yearly or yearly, before any dividend shall be set apart or paid on the Common Stock."

This section was amended in 1901 by the addition of the following:

> "and such dividends may be payable before any dividends shall be set apart or paid on the Common Stock and such dividend may be made cumulative; *provided the corporation shall set apart or pay the said dividends to the holders of the non-cumulative Preferred Stock before any dividends shall be paid on the Common Stock.*"

In addition, Section 47 of the Corporation Act of 1896, provided:

> "The directors of every corporation created under this Act shall in January of each year * * * after reserving over and above its capital stock paid in, as a working capital for said corporation, such sum, if any, as shall have been fixed by the stockholders declare a dividend among its stockholders of the whole of its accumulated profits exceeding the amount so reserved."

The certificates for the Preferred Stock of the United States Cast Iron Pipe & Foundry Company, which were issued under and subject to the above statutory provision, stipulated that the holders shall be "entitled out of any and all surplus net profits, whenever declared by the Board of Directors, to non-cumulative dividends at a rate not to exceed 7% per annum" and if "after providing for the payment of full dividends for any fiscal year on the Preferred Stock, there shall remain any surplus net profits for such year, any of such net profits of *such* year and any other fiscal year after full dividends shall have been paid on the Preferred Stock, shall be applicable to * * * dividends upon the Common Stock".

The Cast Iron Pipe Company had accumulated a reserve for working capital amounting to $2,459,000 from surplus net profits for the years 1900 to 1906 inclusive. Of this reserve $1,593,000 was obtained by scaling down the dividends on the Preferred Stock below the 7% specified in the charter and certificate in four of these years. The company declared a dividend upon the Preferred Stock for the years in which the dividend was scaled down below 7%, such dividend to be paid out of the reserve withheld from the preferred stockholders.

Bassett, a common stockholder, brought suit to enjoin payment of the dividend, contending that dividends on Preferred Stock must be paid out of profits made during the year and that if any such profits were not distributed in that year, they belonged to the common stockholders. The Cast Iron Pipe Company contended that it might pay dividends on the Preferred Stock out of any surplus net profits. The Court of Errors and Appeals held that neither contention was altogether sound; that the corporation could not accumulate a reserve out of earnings which otherwise would be paid as dividends on Common Stock and afterwards use it to pay dividends on Preferred Stock in a year when net profits were insufficient. On the other hand, when a reserve was accumulated by cutting down dividends which otherwise would have been paid to preferred stockholders, such fund so far as it represented moneys so retained, could be availed of for the payment of subsequent dividends on the Preferred Stock.

The Cast Iron Pipe Company continued to accumulate a working capital reserve and at the end of the fiscal year 1922 the amount withheld from the Preferred Stock was $700,000 and from the Common Stock $1,800,000. In 1922 the earnings were over $1,000,000 and after paying a dividend of 5% ($600,000) on the Preferred Stock, the balance ($559,000) was transferred to working capital re-

serve. Later a further dividend of 2% was declared for 1922 and the amount ($240,000) was withdrawn from working capital reserve in order to pay it. In November, 1923, the directors voted to pay the preferred stockholders an additional dividend of one-half of one per cent. and a like dividend upon the Common Stock, these dividends to be drawn from the working capital reserve. The resolution declaring the dividend stated that the amount was no longer needed as working capital and after stating that a dividend of 7% had been paid to the preferred stockholders for 1922, further stated that the payment was out of the net earnings for that year.

Moran, a common stockholder, sued to enjoin the payment of the additional dividend to the preferred stockholders. Day, a preferred stockholder, sued to enjoin the payment of the dividend to the common stockholders. Vice-Chancellor Backes held that the resolution declaring the dividends of the preferred stockholder was lawful, and the Moran bill was dismissed. Referring to Section 18 (supra), the Vice-Chancellor said:

> "This obviously means, as to non-cumulative dividends, that out of the profits of any fiscal year not more than the percentage fixed by the charter shall be paid on such stock for such year, but it does not prohibit the company, after having paid the fixed yearly dividend, from, in the same year, declaring and paying additional dividends out of profits earned in prior years applicable to dividends for such years and which, but for holding them in reserve for economic reasons, would have been distributed in dividends in those years. These profits belong primarily to the preferred stockholders and the directors are in no wise restricted either as to amount, time or occasion when distribution shall be made."

This decision of Vice-Chancellor Backes was unanimously affirmed by the Court of Errors and Appeals (96 N. J. Eq. 698).

In the *Day* case, Vice-Chancellor Backes held that the language of the statute was unmistakable; that the "legislative scheme was to protect the preferred stockholders in their priority rights to dividends over the common stock in all events". The Vice-Chancellor concluded:

> "The statutory ban on payments of dividends on the common stock, until the preferred stockholders have been awarded their just due, is explicit and imperative. The preference clauses in the certificate of incorporation, in so far as they are thus inconsistent with the statute are invalid."

Accordingly, the Vice-Chancellor held that the preferred stockholders were entitled to their preferred dividend as a matter of right, although the time when the obligation was to be performed was largely a matter of discretion with the directors. They could pass dividends if they thought it necessary—"but once having decided to divide the profits, duty supplants discretion, and it becomes incumbent upon the directors to discharge the company's obligation to pay the fixed yearly dividends, and this before any dividend shall be set apart or paid on the common stock, viz. to holders of cumulative dividend shares, all arrearages; to holders of non-cumulative dividend stock, the dividends withheld".

The preferred stockholders were entitled to the reserve profits and "the statutory design was to meet just such a situation as here confronts the preferred stockholders". Accordingly, the dividend to the common stockholders before the preferred stockholders had been paid was held to be unlawful and was enjoined.

This decision was affirmed by a divided Court, seven judges voting for reversal (96 N. J. Eq. 736). The opinion written by Judge White is not the opinion of the Court but is published "as expressing the views of the members of the Court who voted for affirmance", there

being an equal number who voted for reversal. But in writing for affirmance, Judge White noted that the stock in question was preferred within the meaning of the statute and that to allow a dividend upon the Common Stock "while earned available but withheld dividends upon the Preferred Stock for previous years remained undistributed in the surplus of the corporation" would be in conflict with the "legislative scheme or policy".

Judge White construed the corporation's charter to be in conformity with this legislative policy and then stated:

> "There remains for consideration but one point, viz.: Has the status of these preferred stock unpaid dividends for previous years been so fixed and ascertained as available net profits for dividend purposes by action of the Board of Directors as to vest in the preferred stockholders the right here sought to be enforced? We think it has. We fully realize that a mere allegation that dividends have been earned is not sufficient, for in the absence of fraud, actual or constructive, (neither of which is here charged), the dividend rights of stockholders whether preferred or common, are dependent in this respect upon affirmative action of the Board of Directors. * * * But this is not an attempt to force the payment of an undeclared dividend on the preferred stock. The effort here is to prevent the payment of a dividend on the common stock in violation of the priority rights of the preferred shareholders."

This case, while establishing the right of the preferred stockholders of the Cast Iron Pipe Company under the New Jersey statute, does not sustain the claim that in every case where amounts of earnings in prior years have been devoted to proper corporate purposes the preferred stockholders have a substituted lien on subsequent earnings so that they may not be distributed as provided in the certificate of incorporation.

It should not be overlooked that in none of the three New Jersey cases is a single authority except the New Jersey statutes cited in support of any major proposition. The cases are valueless as authority outside of the State of New Jersey. Indeed, it is doubtful whether the cases are even authoritative as a final interpretation of the New Jersey statutes in view of the fact that in the last of the three cases, seven out of fourteen judges did not accept Judge White's view and voted to reverse the judgment.

In 1923 an article by A. A. Berle, Jr., entitled "Non-cumulative Preferred Stock" was published in the Columbia Law Review*. In this article the author on authority of the case of *Bassett* v. *U. S. Cast Iron Pipe & Foundry Company* (supra) asserts that "non-cumulative Preferred Stock carries far greater rights than are usually supposed; that in disregard of these rights many dividends in stock and cash have been paid improperly, with resulting liabilities against those declaring them; that market valuation, corporate accounting and corporate dividend policies in connection with such stock should to some extent be revised". Specifically it is maintained in this essay that earnings withheld from distribution to non-cumulative Preferred Stock do not, as this Court held in *Continental Insurance Company* v. *United States* (supra), constitute assets divisible *pro rata* among stockholders on dissolution, but constitute a special preferred fund which must be segregated on the corporate books for the benefit of Preferred Stock. It is admitted by the essayist that the establishment of a preferred surplus fund will create novel accounting problems with which the Courts "may eventually have to wrestle" but it is urged that these problems are susceptible of a solution favorable to the non-cumulative Preferred Stock.

* 23 Columbia Law Review 158.

This article was followed by editorial comment in the student law reviews asserting on behalf of non-cumulative Preferred Stock rights of which during the forty-year period following the decision of this Court in the *Nickels* case judges, lawyers and accountants alike had been unaware.* This result is sought to be accomplished by evolving or construing from the decisions arising under the statutes of New Jersey a new definition of non-cumulative stock which, if generally applied, would give a meaning different from that commonly understood and heretofore accepted, resulting in widespread disturbance of property rights long vested.

That the Circuit Court of Appeals was influenced by these purely theoretical discussions is manifest from the prevailing opinion written by Circuit Judge Manton (Tr., p. 79).

It is submitted that the conclusions are unsupported by authority and are unsound.

The term "non-cumulative" is descriptive rather than technical; it was devised to describe a stock or bond upon which dividend or interest charges do not accumulate, so as to require liquidation before payment of dividends on junior issues. In short, "non-cumulative" was the negative of "cumulative" and has been so understood for more than half a century.† As well stated in a

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* 27 Columbia Law Review 88 (1927); 36 Yale Law Journal 457 (1927); 11 Virginia Law Review 622 (1925); 76 University of Pennsylvania Law Review 618 (1928). See, however, the countervailing criticism in 12 Cornell Law Quarterly 341 (1929) and 38 Yale Law Journal 1019 (1929).

† Cook, Law of Corporations, (Ed. 8, 1923) 2272.

"When preferred stock is issued it is generally specified in the certificate itself whether it is 'cumulative' or 'non-cumulative'. In the former case all arrears of dividends must be paid on the preferred stock before any dividend is paid on the common. In the latter case the contrary is the rule."

Black's Law Dictionary:

"In the case of 'non-cumulative' preferred stock, its preference for any given year is extinguished by the failure to earn or pay the dividend in that year."

recent review of the present case published in the Cornell Law Quarterly:

> "The terms were considered antithetical. It was the prevalent view and it exists now that a holder of non-cumulative stock had no better right to claim withheld profits than the holder of Common Stock; but if the Directors in their discretion declared a dividend out of current profits the non-cumulatives were entitled to a preference for that fiscal year since." (16 Cornell Law Quarterly 261).

The fact that such has been the common understanding and interpretation of the word during a long period in which vast property rights have vested on the faith thereof permanently fixes its meaning in our law so that any new conception or new definition, unless created by statute or express contract, which alters the word and understanding such property rights must at once be rejected. It is a rule firmly embedded in our jurisprudence that judicial decisions under which property rights have vested will be adhered to, their inherent correctness or incorrectness in the abstract being of less importance than that the rule of property so established should be constant and invariable. (15 Corpus Juris 974). By like principle, the legal significance of language upon which property rights have vested over a long period of time should be held inviolate by the Courts.

Underlying all of the recent scholastic discussions there is but one idea, namely, that a specific equity in undistributed earnings must be given to non-cumulative preferred stockholders in order to protect them from oppression on the part of the common stockholders who ordinarily control the Board of Directors. That common stockholders when they control the Board of Directors (which is not always the case and is not this case) may be tempted to build up corporate property at the expense of non-cumulative preferred stockholders is not a new idea. Apparently the same idea was prominent in

the mind of the Federal Judge whose decision nearly fifty years ago was reversed by this Court in the *Nickels* case. The obvious answer, as pointed out by Circuit Judge Learned Hand in his dissenting opinion in the present case, is that "the law has long advised them that their rights depend upon the judgment of men subject to just (but possible) bias".

That such a speculative argument should be permitted to strike at the very foundation of the law of contracts could seem unthinkable in any case, but manifestly has no legitimate place in the discussion of the relative rights of stockholders in the present case. At the time of the organization of Wabash Railway Company, the Preferred Stock outvoted the Common Stock by two to one and as late as May 1, 1927, there were 693,330.50 shares of Preferred Stock A outstanding as against only 666,977.75 of Common Stock, all of the Preferred Stock B having been converted and extinguished, excepting 24,211.42 shares (Tr., p. 2). During the entire period covered by this litigation, preferred stockholders were unembarrassed by any statutory or contract requirement for cumulative voting and were entitled to elect, and presumably did elect, the entire Board of Directors.

Obviously, the dividend policy was not dictated by the Common Stock, but was the policy sponsored by the Preferred Stock. It appears from the record that during this period there were earnings of $45,563,996., out of which dividends were paid to the Preferred A stockholders in the amount of $8,562,011, and dividend credits were claimed in the amount of $16,127,250, leaving earnings of $21,077,235. applicable to 24,211.42 shares of Preferred Stock B and 666,977.75 shares of Common Stock (Tr., pp. 66-67). It is apparent, therefore, that the present corporate surplus of the Railway Company has been built up at a greater sacrifice of income on the part of the common stockholders than on the part of the holders of

the Preferred Stock A. Moreover, notwithstanding that the contribution of the Preferred Stock A to the prosperity of the Railway Company falls short of that of the Common Stock, the Preferred Stock A is a participating stock and is entitled to share equally with the Common Stock in any distribution of excess earnings.

The possibility that other corporations may have different financial structures with Common stockholders in the majority who may be tempted at times to oppress and depress the non-cumulative Preferred Stock is—if not remediable in the Courts, (which we do not admit)—no justification for re-making of the law of contracts and completely emasculating the sound financial structure of Wabash Railway Company.

The first step in the organization or reorganization of a corporate enterprise is the provision of capital and it developed at an early period that capital did not seek investment in common stocks junior to preferred issues upon which dividends were cumulative; it was found that the cumulative feature tended unduly to depress common stock, restrict its market and embarrass financing. Non-cumulative Preferred Stock was invented as a substitute,—the preferred stockholder to receive only such dividends as should be declared by the Directors in the exercise of a sound discretion except that in any year his preferential dividend must be provided for before any common dividend can be paid for that year. In many cases, perhaps in most cases, the non-cumulative preferred stock was taken by the same interests which purchased the Common Stock and was not marketed as a strictly investment stock until the corporate enterprise, through the judicious investment of current earnings, had been placed in a position strong enough to justify a permanent dividend policy. From data in Poor's Manual of Railroads, it appears that in railroad financing non-cumulative Preferred Stock has been the rule and cumulative Preferred Stock the exception, and it is highly

significant that during the long period which has elapsed since this Court decided the *Nickals* case, there is (a) no record in judicial decisions of a claim that Directors of any important Railway Company have failed to declare preferred dividends which ought to have been declared; (b) no record of the payment in any year by any such company of an extra dividend to non-cumulative Preferred Stock to clear previous "accumulations"; (c) no record of a case (save one that failed) where non-cumulative preferred stockholders have questioned the right of any such corporation to pay dividends on junior issues without first paying dividends earned but undeclared on non-cumulative Preferred Stock.

The exceptional case is *Norwich Water Power Company* vs. *Southern Railway Company*, 11 Virginia Law Register (N. S.) 203. This suit, brought by non-cumulative preferred stockholders of the Southern Railway Company to enjoin payment of dividends on Common Stock, was dismissed by Judge Beverly T. Crump, sitting in the Law and Equity Court of Richmond, Virginia. The exception is more apparent than real, as the case seems to have been inspired by the articles in the Columbia Law Review and the Virginia Law Review, to which we have heretofore referred. Upon the filing of Judge Crump's opinion, the preferred stockholders filed a petition for review by the Supreme Court of Virginia, which was denied. Subsequently, the Supreme Court permitted oral argument upon the question whether an appeal should be granted and after hearing oral argument, the Court again denied the petition. We quote the following from the opinion of Judge Crump:

> "Where the dividends are declared to be non-cumulative, that phrase carried with it the general idea that the dividend, if not declared and paid within any one year, although earnings exist for that year, is lost to the preferred stockholder; that is, that non-cumulative means that the right to the dividend is measured by the action of the

Board of Directors in any one year, and the failure to declare the dividend in any one year prevents it from accumulating as a further charge upon the earnings of the company then existing or which may be subsequently acquired."

The two-fold fallacy of this recent attempt to change the accepted view of non-cumulative Preferred Stock is that it both assumes a wrong and then provides an improper remedy.

As we have already observed, there has been little complaint of the good faith of railway company directors in dealing with non-cumulative preferred stockholders, but it is submitted that the remedy for an exercise of the discretion with which the directors have been invested by law and by which the preferred stockholder has contracted to abide is not an appeal to the Courts to reconstruct the contract. The remedy in such a case must be found within the corporate structure. For this reason, as pointed out by Mr. Chief Justice Taft in *Continental Insurance Company* v. *United States*, (*supra*), a sound financial structure preserves equilibrium of voting power between the different classes of stock.

## II.

**The language of the Preferred A Stock contract of Wabash Railway Company definitely excludes a construction under which the investment of earnings in improvements and equipment or working capital in non-dividend or partial dividend years operates as a permanent restraint against the distribution of earnings of subsequent years.**

Assuming for purposes of argument that in the absence of language showing a contrary intent the term "non-cumulative" may be construed to mean "partly cumulative", it is submitted that such a construction is

foreclosed by the terms of the Preferred A Stock contract of Wabash Railway Company.

The Certificate of Incorporation and Preferred A Stock Certificate (Exhibits A and B to the Bill) both provide that the Preferred A Stock shall be

(a) Entitled to preferential dividends.

(b) in each fiscal year.

(c) before any dividend shall be paid upon other stock.

(d) but such dividend on the 5% Profit Sharing Preferred Stock shall be non-cumulative.

(e) That after the payment or setting apart in any one fiscal year of 5% dividends upon the 5% Convertible Preferred Stock B and upon the common stock of this corporation the 5% Profit Sharing Preferred Stock A shall be entitled to receive additional dividends at the same rate per cent. as any further or additional dividends which may be declared in that year upon such common stock.

(f) That upon liquidation holders of the Preferred A Stock are to be paid the full par value of their shares and "all dividends thereon *declared* and unpaid."

(g) That upon liquidation after payment to the Preferred Stock B and common stock of the par amount of their stock and all dividends thereon declared and unpaid holders of all classes of stock without priority or distinction shall share *pro rata* in the remaining assets of the corporation.

(h) That in event of the conversion of Preferred Stock "B" into Preferred Stock "A" and Common Stock there shall be "a proper adjustment of *declared* but unpaid dividends".

(i) That the 5% Convertible Preferred Stock B shall be entitled to receive preferential dividends in each fiscal year up to the amount of 5% after

payment of the full 5% dividends on the 5% profit sharing Preferred Stock A, but before any dividends shall be paid upon the Common Stock of the corporation.

The foregoing contract in each of its numerous subdivisions and in its entirety not only leaves free and untrammeled the broad discretion vested in the Board of Directors under the *Nickals* case, but clearly shows that accumulation of undeclared dividends could not have been contemplated by the parties.

It is to be noted:

(a) That the Preferred A dividend is "preferential" but not guaranteed or made a charge upon earnings.

(b) That each fiscal year is a separate accounting period and that the preference relates to each accounting period and is not general as in the case of cumulative stock.

(c) That the preference is limited to "dividends" implying the exercise of the ordinary directorial discretion in the creation of a definite legal right.

(d) That the "dividends" are to be "noncumulative," meaning, unless the context shows a different use, the negative of cumulative and as Black says, meaning that "its preference for any given year is extinguished by failure to earn or pay its dividend in that year."

(e) That an additional dividend may be paid upon the Preferred A after paying or setting apart the full dividend in the B stock and 5% on the common, but such additional dividend, like the preferential dividend, is dependent upon (1) a declaration by the Board exercising its discretion which (2) must be made in that year.

(f) That upon liquidation, holders of Preferred Stock A are to be paid the full par value of their shares "and all dividends thereon *declared* and unpaid"—the contract again invoking instead of fettering the ordinary discretion of the directors.

(g) That in like manner the Preferred B and Common Stock are to receive in liquidation the full amount of any "*declared* and unpaid" dividends.

(h) That in event of a conversion of B Stock into Preferred A and Common there is to be an adjustment "of *declared* and unpaid dividends," but if the present contention of the A stockholders is sound, why not an adjustment of *earned* and *undeclared* dividends? Clearly such a contingency was never contemplated by the author of the Preferred A contract.

(i) That by the letter of their contract to which all classes of stock are parties, the Preferred B stockholders are entitled to dividends in any year upon a single condition, namely, that the full 5% dividends shall have been paid upon the Preferred Stock A. In other words, by the letter of his contract, the Preferred B stockholder is entitled to receive payment of the dividend which is enjoined by the decision of the Circuit Court of Appeals.

*It is respectfully submitted that the stipulation that the Preferred B stockholders are entitled to dividends up to 5% in any year in which the full 5% dividend is paid upon the Preferred Stock A is alone determinative of the present case.*

Even if the Preferred Stock A was not expressly stated to be non-cumulative, this clear, definite stipulation that in any year the Preferred Stock B shall be entitled to receive 5% after payment of the full 5% dividend on the Preferred Stock A, would in and of itself

give full non-cumulative character to the Preferred Stock A. This right of the Preferred Stock B to its preferential 5% dividend conditioned *only* upon payment in the particular fiscal year of the full 5% dividend upon the Preferred Stock A is irreconcilable with the theory that prior payment of all dividends earned but unpaid upon the Preferred Stock A in previous years was also in the minds of the parties. To give such an interpretation to the contract, it is necessary to reconstruct it so that it will read as follows:

> "The holders of the Five Per Cent Convertible Preferred Stock B of the Company shall be entitled to receive preferential dividends in each fiscal year up to the amount of Five Per Cent after payment of the full Five Per Cent dividend on the Five Per Cent Profit Sharing Preferred Stock A, (and after further payment of all preferential dividends earned but unpaid thereon in previous years) but before any dividends shall be paid upon the Common Stock, but such preferential dividends shall be non-cumulative, and the holders of the Five Per Cent Convertible Preferred Stock B shall not be entitled to any other or further dividends in any fiscal year."

The addition of the stipulation in brackets works a fundamental change in the agreement of the parties and obviously is inadmissible.

Moreover, it is to be noted that both the Preferred A Stock and the Preferred B Stock are expressly stated to be "non-cumulative" and it is unreasonable to suppose that the term is employed in one sense as applied to the Preferred Stock A and in another sense as applied to the Preferred Stock B; it would be unreasonable to attribute partial or quasi cumulative character to the Preferred Stock A and to deny like character to the Preferred Stock B. It is provided, however, that the Preferred Stock B may receive dividends in any fiscal

year up to 5% but "shall not be entitled to any other or further dividends in any fiscal year". The purpose of this clause was to exclude the Preferred Stock B from participating with the Preferred Stock A and the Common Stock in excess earnings; but the language is unrestricted and is broad enough to exclude the Preferred Stock B from any additional dividend—even a dividend of past earnings. If, however, a postponed dividend of invested surplus earnings had been contemplated the right to receive such a dividend would have been guarded by appropriate language for both the Preferred Stock A and the Preferred Stock B. The use of the term non-cumulative in the same contract to express one idea as to the Preferred Stock A and a different idea as to the Preferred Stock B is foreclosed by elementary rules of construction. Obviously the term non-cumulative was intended to mean precisely what it says as applied to both of the two classes of stock.

There is a further stipulation which is equally incompatible with the theory of a dividend credit or a Preferred Stock surplus. Both the Preferred Stock A and the Preferred Stock B are redeemable at any time after December 1, 1920, at the fixed price of 110% of par. The redemption of either or both of these issues is not conditioned upon the liquidation of any dividend credit or the distribution of any preferred surplus fund, and again it is impossible to apply this new conception of non-cumulative Preferred Stock without interpolating still another clause into a contract drawn by parties who were themselves presumably thoroughly competent to express their own ideas; it becomes necessary to add to the redemption clause a stipulation that the right of redemption shall not be exercised "unless and until the corporation shall have paid all dividend accumulations upon the non-cumulative Preferred Stock so to be redeemed."

Arguments of this character could be multiplied indefinitely, but enough has been said to show that this recent conception of non-cumulative stock, if valid in any case, was not in the minds of the organizers of Wabash Railway Company.

Their purpose was clear.

The reorganized Company was to have two issues of Preferred Stock, each approximately of the same amount and each approximately equal to the amount of Common Stock.

At the outset, the two issues of Preferred Stock represented approximately twice the voting strength of the Common Stock and were in a position to elect the entire Board of Directors.

There could be no change in the voting control earlier than August 1, 1918, when the Preferred Stock B would become convertible, so that control of the Railway Company by its preferred stockholders was assured for at least three years.

After August 1, 1918, conversion of the Preferred Stock B into Preferred Stock A and Common Stock (one-half of each), would increase the voting strength of the Common Stock so that ultimately when all the Preferred B Stock was converted, voting power would be approximately evenly divided between Preferred Stock A and Common Stock. Inasmuch, however, as the conversion process would necessarily extend over a long period of years, it was obvious at the outset that responsibility for the management of the Railway Company during the period of reconstruction would rest with the Preferred Stock.

As an inducement to the holders of the Preferred Stock A to support a conservative dividend policy and permit liberal use of surplus earnings to improve and develop the property and strengthen its earning power, the Preferred Stock A was given the right to participate

equally with the Common Stock in the distribution of surplus earnings in excess of 5%. While the Preferred Stock B was not given the right to participate directly in excess surplus earnings, the holders thereof would ultimately acquire an equal participation therein by conversion of their stock into Preferred Stock A and Common Stock. There was, therefore, an equally strong inducement to the Preferred Stock B to support a policy which would develop and strengthen the earning power of the Railway Company.

The two issues of Preferred Stock were made noncumulative so that the Board of Directors in the exercise of the discretion established by this Court's decision in the *Nickals* case might freely use current earnings for improvements and additions to the property and equipment of the Railway Company to enable it adequately to discharge its public duties.

From the record it appears that approximately $16,000,000 was used for these purposes. These appropriations of earnings were made over a period of more than ten years and at no time during this long period does it appear that there was any claim or suggestion that the Board of Directors, instead of building up property of the Railroad Company for the benefit of all stockholders, were in fact building up a huge dividend credit for the benefit of the Preferred Stock A. It is apparent that the creation of such a dividend credit by judicial decree and the marking of invested surplus to satisfy such a credit would undermine the financial structure of the Railway Company, impair the investment of the common stockholders and cause a widespread disturbance of property rights long vested upon the faith of this Court's decision in the *Nickals* case.

The confusion which such a decision would create and the problems which would arise thereunder are incalculable.

To illustrate:

(1) During the years 1916, 1917 and 1918, there were earnings aggregating $15,486,352 out of which Preferred A dividends were declared and paid in the amount of $2,310,000, leaving a balance of $13,176,352. Against this balance, dividend credits are claimed in the amount of $5,283,225, so that if the accounts of the Railway Company were recast to mark a part of this surplus to the credit of Preferred Stock A, $5,283,225 thereof would be so marked, leaving a balance of $7,893,127 of surplus either free or marked for a junior issue. But in the years 1919 and 1920, there were operating deficits aggregating $9,916,778—an amount sufficient entirely to wipe out either the marked surplus or the free surplus and impinge upon the other, and the question at once arises whether such deficits are to be charged wholly against the marked surplus or wholly against the free surplus, or chargeable pro rata against the marked surplus and the free surplus, or whether, once a dividend credit has accrued, it survives all future deficits as a continuing charge against the future prosperity of the Company. (Tr., pp. 40-42)

(2) It appears from the record that in each of the years 1916 to 1925, inclusive, substantial amounts of Preferred Stock A were issued in conversion of Preferred Stock B, the total outstanding shares of Preferred Stock A increasing from 462,000 in 1917 to 693,056⅔ in 1925. Assuming that the issue of these new Preferred A shares was distributed over a twelve months period in each year in which a dividend credit is claimed to have accrued, there are a minimum of 84 dividend credits, each differing in amount, applicable to the stock outstanding in 1925 which would give 84 different values to an issue of stock, the shares of which are listed on the New York Stock Exchange and have always been bought and sold upon the assumption that all shares had the same value. (Tr., pp. 40-42)

A judicial decision construing a contract so as to create such manifest abuse could only be justified by language showing an unmistakable intent.

It is submitted that the Preferred A Stock contract shows a different intent.

## III.

### An analysis of the authorities relied upon by the respondents fortifies the legal conclusions above expressed.

An exhaustive review of the authorities relied upon by the respondents would be unprofitable. They are reviewed in the opinion of the Circuit Court of Appeals and the dissenting opinion of Circuit Judge Learned Hand. All of them will be found either distinguishable and inapplicable or to fortify the legal conclusions above expressed. The case of *Dent v. London Freehouse Company*, L. R. 16 Ch. Div. 344, may be passed over. This case together with *Boardman v. Lake Shore & Michigan Southern Railway Company*, 84 N. Y. 157, is distinguished by this Court in its opinion in the Pathé case. The cases of *Wood v. Lary*, 47 Hun 100, and *Bard v. Ottawa Gas and Electric Company*, 133 Fed. 967, were based upon contracts under which the Board of Directors had no discretion. The cases arising under the New Jersey statute have already been discussed and have been shown to have no value as authority outside of the State of New Jersey. The case of *Star Publishing Company v. Bird*, 134 N. E. 205, involved a flagrant breach of discretion on the part of the directors and was correctly decided. The facts are important. The Star Publishing Company was an industrial corporation organized under the laws of Indiana, having outstanding non-cumulative preferred stock and common stock. From

1908 to the time of the institution of the suit, the Publishing Company was prosperous and it appears from the opinion of the Supreme Court of Indiana that from 1911 to 1918 the company could have paid on the first days of March, June, September and December, dividends at the rate of 5% per annum on its preferred stock without depleting its cash assets, impairing its solvency, injuring its business or the rights of its shareholders. During this period the Board of Directors withheld payment of dividends upon the preferred stock and the Supreme Court held that as to at least a part of this period, there had been a gross breach of discretion. It accordingly decreed the payment of dividends upon the preferred stock to the extent of $39,050, although the amount of unpaid dividends on the preferred stock was actually $62,125. Notwithstanding the fact that $23,075 of preferred dividends were earned and unpaid, the Court approved the payment of a dividend upon the common stock. It is submitted that this decision under which a dividend was decreed to be paid upon common stock although dividends on the non-cumulative preferred stock were unpaid during a long period in which they were regularly earned, definitely commits the Supreme Court of Indiana—the State of the domicile of Wabash Railway Company—to the traditional conception of non-cumulative preferred stock.

The respondents, in support of their contention rely strongly upon *Collins* v. *Portland Electric Power Company*, 12 Fed. Rep. (2nd Series) 671 (1926).

The certificate for the Second Preferred Stock of the Portland Electric Power Company provided that:

> "The holders of the second preferred stock are entitled to receive, when and as declared, out of the surplus or net profits of the Company, dividends at the rate of 6% per annum, payable as the board of directors may determine, before any dividends shall be set apart for or paid upon the common stock."

The certificate further provided that dividends might be paid upon the common stock, provided that

> "dividends on the second preferred stock at the rate of 6% per annum for a period of 6 months immediately preceding the day on which the common stock dividend shall have been paid in full."

The litigation which included cross-suits by the second preferred stockholders and common stockholders involved dividends for the years 1920, 1921, 1923 and 1924. In every year previous to 1920 the earnings were insufficient to pay dividends on the cumulative preferred stocks prior to the second preferred stock. In 1920 they were sufficient to provide for dividends for that year on these prior stocks but not for arrears of cumulative dividends thereon. In 1921 and 1923 the earnings were sufficient to pay dividends on all prior stocks, including arrears of cumulative dividends thereon, with a balance for the second preferred. Prior to suit brought a dividend of 1½% for 1923 was paid upon the second preferred stock. In 1924 large earnings were made and in March, 1925, additional dividends of ½ of 1% were declared upon the second preferred stock for each of the years 1920, 1921 and 1923 thus making a total of 3 per cent. declared in dividends on the second preferred stock. In April 1925 a common dividend of 10¢ per share was declared for 1924.

The common stockholders asked for an injunction restraining the payment of the dividend on the second preferred stock for 1920, 1921 and 1923 upon the ground that there were no distributable earnings for 1920 and that an unearned non-cumulative preferred dividend could not be fastened upon the profits of future years and that any right to a dividend for each of these three years was lost when the Board failed to make a seasonable declaration.

The preferred stockholders asked for an injunction restraining the payment of the dividend on the common stock for 1924 on two grounds:

FIRST.—That no distribution could be made upon the common stock until all *earned,* but undeclared preferred dividends were liquidated.

SECOND.—That no distribution of 1924 earnings could be made upon the common stock until the whole and not merely a *pro rata* part of the 6% dividend was paid upon the second preferred stock.

The Court held that payment of the dividend on the common stock should be enjoined upon the ground *last* stated; that payment of the 1920 dividend on the second preferred stock should be enjoined because not earned; and that the 1921 and 1923 dividends on the second preferred were not improper because of the belated character of the declaration.

In appraising this decision it is important to bear in mind that a determination of the fundamental contention of the preferred stockholders, namely, that the preferred dividend was a fixed charge upon net earnings, would have disposed of all points in controversy and would have rendered unnecessary (a) the decision that the discretionary power of the Board in the matter of dividends is not lost if not immediately exercised, and (b) the decision that notwithstanding the six months' clause a dividend could not be paid in any year upon the common stock until the full 6% was declared upon the second preferred stock. That the Court based its decision upon the determination of these two latter propositions indicates clearly that the novel theory advanced by the respondents was not accepted by the Court.

The foregoing cases are believed to cover substantially the entire field.

In only two cases, namely, *Wood* v. *Lary* and *Burk* v. *Ottawa Gas and Electric Company,* was the non-cumulative clause given the unusual meaning for which Wabash Preferred A stockholders are now contending, and in each of these cases by explicit terms of the stock contract the obligation of the Company to pay the dividend if earned was fixed and definite and the Board of Directors had no discretion whatever.

In one of the petitions for a writ of certiorari in the present case, the attention of this Court is called to the case of *Missouri Pacific Railroad Company* v. *Texas and Pacific Railway Company and others,* 282 Fed. Rep. 61, (1922). In that case, the Circuit Court of Appeals for the Fifth Circuit, following the decision of this Court in the *Nickals* case, held that income bondholders were not entitled in later years to recover out of accumulated surplus interest for years in which the Board of Directors determined that the current earnings ought to be invested in road and equipment. If an income bondholder must lose his claim to interest when earnings which might have been applied thereto are invested in road and equipment, it is difficult to reconcile such conclusion with the decision of the Circuit Court of Appeals for the Second Circuit in this case, which gives a superior position to non-cumulative Preferred Stock.

## IV.

**The decision of the Circuit Court of Appeals should be reversed and the case remanded to the Circuit Court of Appeals under a mandate for affirmance of the decree of the District Court.**

Respectfully submitted,

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## APPENDIX.

**Extract from Certificate representing Five per cent. Profit-sharing Preferred Stock A Wabash Railway Company.**

"The holders of the Five Per Cent. Profit Sharing Preferred Stock A of the Company shall be entitled to receive preferential dividends in each fiscal year up to the amount of five per cent. before any dividends shall be paid upon any other stock of the Company, but such preferential dividends shall be non-cumulative. The holders of the Five Per Cent. Convertible Preferred Stock B of the Company shall be entitled to receive preferential dividends in each fiscal year up to the amount of five per cent. after payment of the full five per cent. dividend on the Five Per Cent. Profit Sharing Preferred Stock A, but before any dividends shall be paid upon the Common Stock, but such preferential dividends shall be non-cumulative, and the holders of the Five Per Cent. Convertible Preferred Stock B shall not be entitled to any other or further dividends in any fiscal year. After the payment or the setting apart in any one fiscal year of five per cent. dividends upon the Five Per Cent. Convertible Preferred Stock B, and upon the Common Stock, the holders of the Five Per Cent. Profit Sharing Preferred Stock A shall be entitled to receive additional dividends at the same rate per cent. as any further or additional dividends which may be declared in that year upon the Common Stock. The Five Per Cent. Profit Sharing Preferred Stock A shall at the option of the Company, be redeemable as an entirety at any time after December 1, 1920, upon twelve weeks' notice at the price of One Hundred and Ten per cent. of its par value, and the Five Per Cent. Convertible Preferred Stock B, at the option of the Com-

pany, shall be redeemable as an entirety at any time after December 1, 1920, upon like notice and at the same price. The holders of the Five Per Cent. Convertible Preferred Stock B may at any time after August 1, 1918, and up to thirty days prior to any date fixed for the redemption of the entire issue of Five Per Cent. Profit Sharing Preferred Stock A, convert the same into and exchange the same for Five Per Cent. Profit Sharing Preferred Stock A and Common Stock at the rate of Fifty Dollars ($50) par value of Five Per Cent. Profit Sharing Preferred Stock A, and Fifty Dollars ($50) par value of Common Stock for each One Hundred Dollars ($100) par value of Five Per Cent. Convertible Preferred Stock B, with a proper adjustment of declared and unpaid dividends. In the event of any liquidation, dissolution or winding up (whether voluntary or involuntary) of the Company, (1) the holders of the Five Per Cent. Profit Sharing Preferred Stock A shall be entitled to be paid in full out of the assets of the Company the par amount of their stock and all dividends thereon declared and unpaid before any amount shall be paid out of said assets to the holders of any other stock of the Company, (2) the holders of the Five Per Cent. Convertible Preferred Stock B shall then be entitled to be paid in full out of the assets of the Company the par amount of their stock and all dividends thereon declared and unpaid before any amount shall be paid out of said assets to the holders of the Common Stock (3) the holders of the Common Stock shall then be entitled to be paid in full out of the assets of the Company the par amount of their stock and all dividends thereon declared and unpaid, and (4) thereafter the holders of all classes of stock of the Company, without priority or distinction as between the different classes thereof, shall be entitled to participate pro rata in the remaining assets of the Company. Holders of all shares of stock of the Company have equal voting rights share for share alike."

## Extract from Certificate of Incorporation of Wabash Railway Company.

"The Five Per Cent. Profit Sharing Preferred Stock A shall be entitled to receive preferential dividends in each fiscal year up to the amount of five per cent. before any dividends shall be paid upon any other stock of this corporation, but such dividends on the Five Per Cent. Profit Sharing Preferred Stock A shall be non-cumulative. After the payment or the setting apart in any one fiscal year of five per cent. dividends upon the Five Per Cent. Convertible Preferred Stock B and upon the Common Stock of this corporation, the Five Per Cent. Profit Sharing Preferred Stock A shall be entitled to receive additional dividends at the same rate per cent. as any further or additional dividends which may be declared in that year upon such Common Stock. The Five Per Cent. Profit Sharing Preferred Stock A shall, at the option of this corporation, be redeemable as an entirety at any time after December 1, 1920, upon twelve weeks' notice, at the price of one hundred and ten per cent. (110%) of its par value. In the event of any liquidation, dissolution or winding up (whether voluntary or involuntary) of this corporation, the holders of the Five Per Cent. Profit Sharing Preferred Stock A shall be entitled to be paid in full, out of the assets of this corporation, the par amount of their stock and all dividends thereon declared and unpaid, before any amount shall be paid out of said assets to the holders of any other stock of this corporation; but after payment in full to the holders of the Five Per Cent. Convertible Preferred Stock B and Common Stock of this corporation of the par amount of their stock and all dividends thereon declared and unpaid, holders of all classes of stock of this corporation, without priority or distinction as between the different classes thereof, shall be en-

titled to participate pro rata in the remaining assets of this corporation.

The Five Per Cent. Convertible Preferred Stock B shall be entitled to receive preferential dividends in each fiscal year up to the amount of five per cent. after payment of the full five per cent. dividends on the Five Per Cent. Profit Sharing Preferred Stock A, but before any dividend shall be paid upon the Common Stock of this corporation. Said dividends shall be non-cumulative, and the Five Per Cent. Convertible Preferred Stock B shall not be entitled to any other or further dividends in any fiscal year. The holders of the Five Per Cent. Convertible Preferred Stock B may, at any time after August 1, 1918, and up to thirty days prior to any date fixed for the redemption of the entire issue of Five Per Cent. Profit Sharing Preferred Stock A, convert the same into, and exchange the same for, Five Per Cent. Profit Sharing Preferred Stock A and Common Stock of this corporation. For the purpose of such conversion this corporation shall have power, from time to time, to issue such amounts of its Five Per Cent. Profit Sharing Preferred Stock A and Common Stock in addition to the amounts hereby specifically authorized as may be necessary. Such conversion shall be at the rate of Fifty Dollars ($50) par value of Five Per Cent. Profit Sharing Preferred Stock A and Fifty Dollars ($50) par value of Common Stock for each One Hundred Dollars ($100) par value of Five Per Cent. Convertible Preferred Stock B, with a proper adjustment of declared and unpaid dividends. The Five Per Cent. Convertible Preferred Stock B shall, at the option of this corporation, be redeemable as an entirety at any time after December 1, 1920, upon twelve weeks' notice, at the price of one hundred and ten (110%) per cent. of its par value. In the event of any liquidation, dissolution or winding up (whether voluntary or involuntary) of this corporation, the holders of the Five Per

Cent. Convertible Preferred Stock B, shall be entitled to be paid in full, out of the assets of this corporation, the par amount of their stock and all dividends thereon declared and unpaid, before any amount shall be paid out of said assets to the holders of the Common Stock; but after payment in full to the holders of the Common Stock of the par amount of their Common Stock and all dividends thereon declared and unpaid, holders of all classes of stock of this corporation, without priority or distinction as between the different classes thereof shall be entitled to participate pro rata in the remaining assets of this corporation."